DUKE ENERGY

Public Service Commission of South Carolina Allowable Ex Parte Briefing

Tax Cuts and Jobs Act

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- Overview of the Tax Cuts and Jobs Act Impacts for Utilities[1]
- Corporate Income Tax Reduction
- Tax Normalization
- Deferred Taxes
- Bonus Depreciation
- Excess Deferred Income Taxes
- Duke Energy Carolinas and Duke Energy Progress Proposal[2]

1 https://www.congress.gov/bill/115th-congress/house-bill/1

2 https://dms.psc.sc.gov/Web/Dockets/Detail/116871 and https://dms.psc.sc.gov/Web/Dockets/Detail/116872

The Tax Cuts and Jobs Act was passed into law on December 22, 2017 with the majority of the provisions taking effect January 1, 2018.

Key Provisions of The Tax Cuts and Jobs Act for Utilities	
Provision	**Impact to Customer Rates**
Reduction of the corporate tax rate from 35 percent to 21 percent	+ and -
Elimination of bonus depreciation	-
Normalization of excess accumulated deferred income taxes (ADITs) resulting from the Tax Act.	+ and -
Retention of net interest expense deductibility	+
Elimination of the manufacturing deduction	-

Cost of service and customer rates will be impacted by the TCJA in two significant ways.

Revenue Requirements = Operating Expense + (Rate Base x Cost of Capital)

- There are 2 large items in cost of service, and therefore customer rates, related to federal income taxes.

  1. Income tax expense – based on the federal income tax rate.
     - Included in revenue requirements as a component of operating expense.
  2. Deferred income taxes – originate from the timing difference between when federal tax is collected in rates and when the actual payments are made to the IRS.
     - Included in revenue requirements as a reduction to rate base.

Customer Impact

- The new statutory income tax rate of 21% is a reduction from the previous rate of 35%.
- This will lower a key component of cost of service, i.e., income taxes.
- Current rates were established when the income tax rate was 35% and will be reduced to reflect the new rate of 21% in the current rate cases.
- The Company has been deferring the amount of revenue associated with the higher tax rate since January 1, 2018 and is proposing to return that overcollection of revenue in the current rate cases.

This positive impact to customers rates will be somewhat offset because:

- Rate base will be higher in future rate proceedings due to the reduction in the deferred tax offset to rate base as a result of the lower federal income tax rate (discussed on subsequent slides).

Utilities must comply with IRS rules regarding tax normalization.

Ratemaking (“book taxes”)

- The IRS requires utilities to include income tax expense in cost of service based on straight-line depreciation (spreads to cost over the life of the asset).
- This meets the IRS requirements for normalization and accomplishes the proper allocation of tax expense to present and future customers.

Tax payments (“cash taxes”)

- Depreciation expense for tax purposes is based on IRS rules that allow companies to take accelerated tax deductions for recovery of the cost of an asset over a shorter period than its life in order to provide the company with cash for reinvestment and economic growth.
- In effect, the government allows companies to defer the payment of taxes to later years so that companies can invest the cash that would have otherwise been paid today into new assets and economic growth without having to raise capital from debt or equity financings, thereby lowering financing costs for utilities and their customers.

Deferred taxes

- The timing difference between “cash taxes” and “book taxes” is what is referred to as deferred taxes.
- Deferred taxes represent the timing difference between when a utility pays a tax to the IRS and when a utility collects for that tax payment through customer rates.
- The majority of a utility’s deferred taxes result from accelerated tax depreciation, however, there are other timing differences related to when items are deducted for book purposes and when they are deducted for tax purposes that also create deferred tax balances.

- Tax normalization is a general ratemaking policy.
- It requires utilities to recognize the benefits of depreciation expense tax deductions in customer rates over the life of assets.
- If a utility fails to meet the requirements for tax normalization, it will no longer be allowed to use accelerated depreciation for tax return purposes.
- This would result in:
  - Much higher current tax payments
  - No interest free cash (i.e. government loan) which would have to be replaced with debt and equity financings.
  - Much higher rate base (and therefore higher customer rates) due to the elimination of deferred taxes.

Accumulated Deferred Income Tax (ADIT) Example

Deferred taxes are a by-product of tax normalization and an important ratemaking component.

Assumptions:

- Company invests $1,000 in an asset with a useful life of ten years
- Company is allowed to accelerate the depreciation of the investment over 5 years for tax purposes (the IRS provides tables that are used to calculate the annual tax depreciation expense)
- Federal income tax rate is 21%

Year	Depreciation Expense			Deferred Tax	
	Per Books	Per Tax	Difference	Current Year (1)	Accumulated (2)
1	$100	$200	$100	$21	$21
2	$100	$320	$220	$46	$67
3	$100	$192	$92	$19	$87
4	$100	$115	$15	$3	$90
5	$100	$115	$15	$3	$93
6	$100	$58	$(42)	$(9)	$84
7	$100	-	$(100)	$(21)	$63
8	$100	-	$(100)	$(21)	$42
9	$100	-	$(100)	$(21)	$21
10	$100	-	$(100)	$(21)	$0
	$1,000	$1,000	$0	$0	$0

(1) A positive number in this column indicates the Company is paying less tax than it is collecting in rates. A negative number in this column indicates the Company is paying more tax than it is collecting in rates.

(2) The balance in this column represents cash that the Company has collected for future payments to the IRS. This balance benefits customers through a reduction to rate base. Because deferred tax balances are a timing difference only, they will always go to $0 over the life of the asset.

Bonus depreciation is an enhanced form of accelerated depreciation for tax purposes and allowed utilities to defer even larger tax payments to future periods.

- Prior to the passage of the TCJA, bonus depreciation had existed for well over a decade to encourage capital investment.
- In 2017, bonus depreciation was 50 percent – this means that corporate taxpayers could depreciate for tax purposes 50 percent of property placed in service in the first year *in addition to* a normal level of tax depreciation on the remaining 50 percent.

Year	Depreciation Expense					Deferred Tax	
	Per Books	Bonus per Tax	Normal per Tax	Total per Tax	Per Books vs. Tax Difference	Current Year	Accumulated
1	$100	$500	$100	$600	$500	$105	$105
2	$100		$160	$160	$60	$13	$118
3	$100		$96	$96	$(4)	($1)	$117
4	$100		$57.5	$57.5	$(42.5)	($9)	$108
5	$100		$57.5	$57.5	$(42.5)	($9)	$99
6	$100		$29	$29	$(71)	($15)	$84
7	$100		-	-	$(100)	($21)	$63
8	$100		-	-	$(100)	($21)	$42
9	$100		-	-	$(100)	($21)	$21
10	$100		-	-	$(100)	($21)	$0
	$1,000	$500	$500	$1,000	$0	$0	$0

The elimination of bonus depreciation lowers ADIT in the future leaving the utility with less cash to fund ongoing operations and investments.

- The TCJA generally provides that corporations may immediately expense capital as it is placed in service, akin to 100% bonus depreciation.
- However, the TCJA specifically prohibits the immediate expensing of capital by regulated utilities.
- Utilities are directed to use normal tax depreciation for property investment placed in service (i.e. eliminating bonus depreciation).

Accumulated Deferred Income Tax (ADIT)			
Year	**Without Bonus**	**With Bonus**	ADIT represents cash that the Company has collected for future payments to the IRS. This cash is used to fund investments of the utility and avoid 3rd party financing (debt or equity). Because utilities were afforded large deductions as a result of bonus depreciation, they often paid little to no cash taxes in any given year.
1	$21	$105	
2	$67	$118	
3	$87	$117	
4	$90	$108	
5	$93	$99	
6	$84	$84	
7	$63	$63	
8	$42	$42	
9	$21	$21	
10	$0	$0	
	$0	$0	

The reduction in the corporate income tax rate means utilities will pay less in taxes in the future than they previously expected.

- As illustrated on previous slides, utilities have deferred tax balances (money that has been collected from customers but not yet paid to the IRS).
- This money was collected assuming those taxes would be paid in the future at a 35% corporate income tax rate.
- Because the corporate income tax rate was reduced to 21%, utilities have excess deferred tax balances equal to the difference between what will be paid at the 21% rate compared to what would have been paid at the 35% rates.
- These excess deferred tax amounts will be refunded to customers.

Year		Deferred Tax at 35%			Deferred Tax at 21%		Deferred Tax Balances Post Tax Reform	
		Difference (from previous slide)	Current Year	Accumulated	Current Year	Accumulated	Excess	Restated Accumulated
1	2014	$500	$175	**$175**	$105	**$105**		
2	2015	$60	$21	**$196**	$13	**$118**		
3	2016	$(4)	($1)	**$195**	($1)	**$117**		
4	2017	$(42.5)	($15)	**$180**	($9)	**$108**	$72	**$108**
5	2018	$(42.5)			($9)	**$99**		**$99**
6	2019	$(71)			($15)	**$84**		**$84**
7	2020	$(100)			($21)	**$63**		**$63**
8	2021	$(100)			($21)	**$42**		**$42**
9	2022	$(100)			($21)	**$21**		**$21**
10	2023	$(100)			($21)	**$0**		**$0**
		$0			$0	**$0**		**$0**

Types of Excess Deferred Income Tax (EDIT)

There are three categories of excess deferred income tax.

1. Protected EDIT
   - Generally related to a company's investment in property, plant and equipment
   - The flow back treatment is expressly made subject to IRS normalization rules by the Tax Act.
   - The normalization rules require protected EDIT to be flowed back over the remaining lives of the property giving rise to the deferred tax balance.
   - The amortization period is called the Average Rate Assumption Method ("ARAM").
2. Unprotected Property, Plant & Equipment EDIT
   - Subject to flow back over a timeframe determined by the Commission.
   - Because this EDIT is related to property, it is reasonable to also flow these amounts back over the remaining lives of the property giving rise to the deferred tax balance.
   - The gradual return of EDIT over the life of the capital asset being depreciated, aligns with when these taxes would have been paid, balances the customer and the Company's interests, protects the Company's cash flow and also protects the customer against rate volatility.
3. Unprotected Non-Property, Plant & Equipment EDIT
   - Subject to flow back over a timeframe determined by the Commission

Customers will receive the benefits of the TCJA.

Revenue Requirements = Operating Expense + (Rate Base x Cost of Capital)

Revenue Requirement Component	Revenue Requirement Impact	Customer Rate Impact
Operating Expense	Goes down due to the lower federal tax rate	Reduces customer rates
Rate Base	Goes up due to: 1. The return of the excess deferred income taxes 2. Lower deferred taxes on a go-forward basis because they will be based on a 21% rate rather than a 35% rate 3. Lower deferred taxes on a go-forward basis due to the elimination of bonus depreciation	Increases customer rates as rate base grows

Company's Proposal for Including the Benefits of the TCJA in Customer Rates

- Under the Company's proposal, customers receive benefits in two primary ways:
  1. EDIT Rider – return of revenue deferral and excess deferred income taxes, adjusted annually
  2. Base Rates – decrease in ongoing income tax expense

Total Customer Benefit Proposed		
	DEC	DEP
EDIT Rider Benefit	$61.9 million 3.7%	$9.9 million 1.7%
Base Rates Benefit	$66.3 million 3.9%	$16.8 million 3.0%
Total Customer Benefit	$128.2 million 7.6%	$26.7 million 4.7%

Company's Proposal for Including the Benefits of the TCJA in Customer Rates
EDIT Rider Benefit

Year 1 Customer Benefit Impact of the EDIT Rider

	Total Deferred Amounts		Proposed Amortization Period	Year 1 Rider Amounts	
	DEC	DEP		DEC	DEP
Jan 1-Dec 31, 2018 deferred revenue	$30 million *	$2 million *	5 years	$5.9 million	$0.5 million
Protected	$411 million	$147 million	ARAM period	$10.4 million	$5.4 million
Unprotected PP&E related	$270 million	$58 million	20 years	$13.4 million	$2.9 million
Unprotected non-PP&E related	$68 million	$5 million	5 years	$13.6 million	$1.0 million
NC EDIT				$17.3 million	$1.1 million
Return				$1.0 million	-$1.1 million
Total EDIT Rider				$61.9 million 3.7%	$9.9 million 1.7%

* These amounts have been reduced by $40M for DEC and $13M for DEP to offset the solar rebate regulatory asset related to the Distributed Energy Resources Program (DERP). The Company will continue to defer the impact of the tax rate reduction from January 1, 2019 through the new rates effective date in this case. Those additional amounts are not known at this time, but will also be returned to customers.

Company's Proposal for Including the Benefits of the TCJA in Customer Rates
Revenue Deferral

- In order to determine the amount of current revenue to defer:
  - The Company identified the amount of income tax expense currently in rates based on the test year cost of service from the most recent rate case.
  - Restated that income tax expense amount to a 21% rate.
  - Took the difference and developed a cents/kwh rate based on the kwh in the test year from the most recent rate case.
  - Multiplies that cents/kwh rate times kwh sales each month and defers that revenue amount to be returned to customers.

Example	Tax Rate at 35%	Tax Rate Restated to 21%	Overcollection in Current Rates
Federal taxes included in cost of service in last rate case			
Current	$25,000	$15,000	$(10,000)
Deferred	$110,000	$66,000	$(44,000)
Total	$135,000	$81,000	$(54,000)
Increase to rate base due to lower deferred tax balance		$44,000	
Return on Increased Rate Base		7.27%	$3,199
Total amount in current rates related to 35% income tax rate vs 21% income tax rate			$(50,801)
Grossed up to pre-tax revenue requirement level			$(64,305)
SC retail billed kwhrs in test year for last rate case			20,750,000
Cents/kwh overcollection in current rates			(0.00310)

Customers benefit from the adjustment to reflect lower ongoing income tax due to the tax rate change from 35% to 21%.

Base Rates Customer Benefit Proposed		
	DEC	DEP
Change in Ongoing Income Tax Expense	\$66.3 million 3.9%	\$16.8 million 3.0%

It is appropriate to consider how the TCJA impacts a utility's cash flow.

- As stated previously, Accumulated Deferred Income Taxes represent cash that the Company has collected for future payments to the IRS. This cash is used to fund investments of the utility and avoid 3rd party financing (debt or equity).
- The combination of a lower tax rate, the loss of bonus depreciation, and the need to return to customers the excess deferred income taxes, means that utilities will lose some of the cash flow contribution from deferred taxes on an ongoing basis.
- This pressure on cash flow has the potential to have an overall negative credit impact on utilities.
- Credit quality drives access to affordable capital, therefore, it is in the best interest of customers to prevent a weakening of the Company's cash flow and credit quality from pre-Tax Act levels.
- The Company's proposal included in this case provides immediate benefits as well as ongoing benefits through the return of deferred taxes over time.